GEARING UP FOR REGULATION 2.0

GEORG SERENTSCHY develops the regulatory picture in Europe and argues for a much more ambitious agenda for investment

There is much agreement among industry experts that the current regulatory framework in Europe shows clear signs of obsolescence and should be – without further delay – fundamentally overhauled. All sides call for a more cohesive approach and the formation of a coherent industrial policy for the telecoms sector so that it is better able to compete against its global rivals in terms of investment ability, innovation adoption, network capability and attractive unit pricing.

Along the future regulatory trajectory in Europe, there are a series of challenging issues and required steps for regulatory modernisation to be dealt with. When defining the trajectory of regulatory modernisation, Europe should avoid going for incremental improvement only and rather aim at an ambitious scenario and step up to a 'virtuous circle', based on innovation, investment and smart regulation ('Regulation 2.0).[1]

This is the key point I argue in this article, which is based on an earlier version published on my website.[2] I also take into account relevant parts of the most recent net neutrality debate in the US and EU and an article (Adapt or die) about Europe by Richard Feasey.[3]

The European telecoms sector is faced with significant challenges in terms of rapidly emerging new technologies and new forms of competition and business models driven by these technology changes. This year will be pivotal for European policymakers, regulators and competition watchdogs to improve the environment for the European telecoms sector.

The current debate in Europe is strongly driven by the controversial issues in the Connected Continent proposal raised by the European Commission in October 2013 and since then subject to oscillating debates between the European Parliament and the European Council. The current state of play obviously has been narrowed down to two focal points, net neutrality and roaming, both under the heading of a single telecoms market.

Richard Feasey pointed out in his Intermedia article that – in his view – it remains unclear why a 'single market' for the telecoms sector is an appropriate answer to the sector's challenges. His point prompted me to focus even more on the most relevant question in this regard: what can regulation do to promote more investment in the sector?

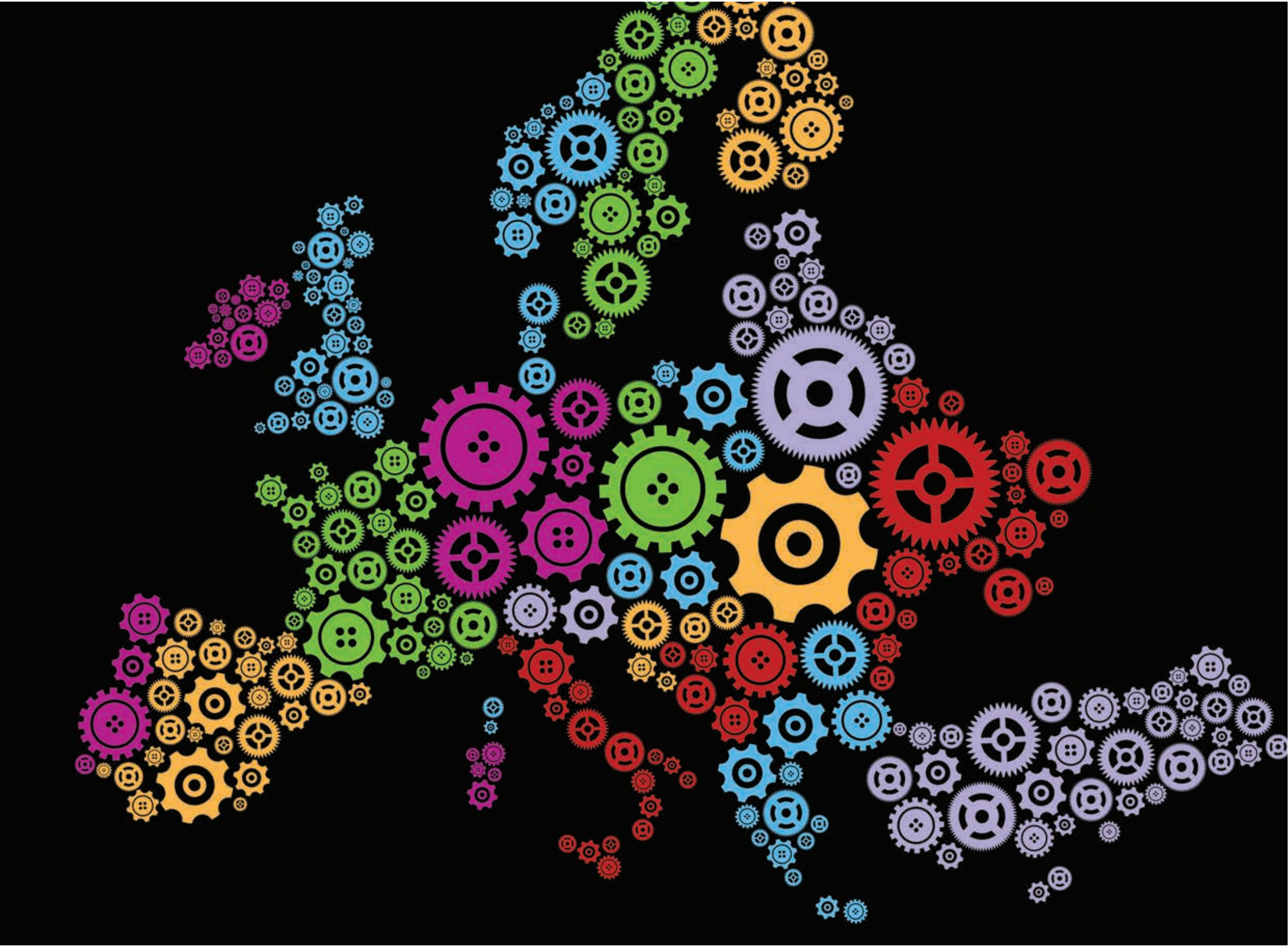
REGULATION AND INVESTMENT

Regulation is the single most important driver in the telecoms sector. HSBC's Global Regulatory Heatmap report[4] aims to take the regulatory temperature globally and to identify those countries where regulation is most and least supportive of investment, and then to assess how the world's largest operators are exposed to these conditions. The report shows that Europe has faced the harshest regulation, although there are now encouraging indications of improvement. (See also Intermedia vol 42 issue 4/5 2014/15 for an extract of this HSBC report, which is not publicly available.)

The telecoms sector is widely regarded as an enabler of innovation, productivity growth and international work sharing in the context of an increasingly competitive and globalised economy. Academic research indicates that economic progress in any given country is driven less by the mere arrival of new technologies, and more by the speed, breadth and depth of their adoption. Consequently, it is tremendously important that network operators invest heavily so as to ensure that the latest telecoms technologies are available on as ubiquitous a basis as possible.

Network investment is important for another reason also: as set out in another HSBC report, Supercollider,[5] it can be clearly demonstrated that the primary driver of lower prices in telecoms is capital expenditure (capex). In deploying more of the most modern systems, operators take advantage of new technology that is the basis for innovation and capable of handling traffic with greater efficiency, and thus at lower unit cost. As pointed out in Supercollider, this mechanism is a classic example of dynamic efficiency gains in action. Lowering unit costs and prices should be a primary policy goal, as it is this that enables the development and adoption of novel applications and contributes towards productivity growth in the broader economy. However, it has to be mentioned that there is a Babylonian confusion in the public debate on 'price', meaning either the monthly bill or the price per unit (megabyte, text, minute voice).

This obviously raises the question of what might induce operators to raise their capex, and here the empirical evidence is plain. The most effective drivers of higher network spending is a higher EBITDA (earnings before interest, taxes, depreciation and amortisation) margin for mobile operators, and



competition, as they give mobile operators both the means and the incentive to invest. In the absence of competition, this policy could lead to the creation of a monopoly offering the highest margins without any incentive to invest. See also Philippe Aghion's paper on the relation between ability and incentive to invest and relevant margins ('inverted U').[6]

So the main challenge facing regulatory policymakers is how best to secure a benign investment environment, in which healthy margins support heavy capex. To this end it has to be kept in mind that regulation is the single most important driver for securing sufficient EBITDA margins.

However, the current regulatory framework in Europe lacks incentives to invest and shows clear signs of obsolescence. Therefore it should be fundamentally overhauled in the course of the next framework review process. To name only two examples of obsolescence:

- The current framework is too narrowly focused on legacy apps – it is still centred on traditional voice telephony, text messages and broadcast TV, which are now just legacy applications in a much bigger space, ie. digital services
- The current framework is inherently slow, leading to inappropriate multi-year/multi-step iterative procedures that fail to keep pace with market and technology evolution.

Along the future regulatory trajectory in Europe, there are a series of challenging issues and required steps for regulatory modernisation. This is where incremental improvement should be avoided and ambition needed for a 'virtuous circle' based on innovation, investment and smart regulation (Regulation 2.0). The following list of issues is not comprehensive and the order does not indicate priority.

CHALLENGING ISSUES FOR THE TELECOMS SECTOR

From traditional telco services to internet-based ecosystems: significant market power (SMP) regulation

In the telecoms legacy world, operators acted as gatekeepers aiming at monetising single products or integrated value chains. Now, ecosystems controlled by the internet giants (over-the-top [OTT] players or 'edge providers') are the new competitive engines that capture and deliver value. These competitors were never foreseen by regulators, and yet have amassed customer bases that dwarf those of even the largest telecoms companies (for example the merged Facebook/ WhatsApp conglomerate). The emergence of such powerful forces does prompt the question of whether conventional regulation of the sector, stratifying the industry between incumbents obliged to provide wholesale capacity and resellers able to obtain this capacity on favourable wholesale terms, still remains appropriate.

> **"The current framework is too narrowly focused on legacy apps and is inherently slow."**

The first meeting of the single digital market project team under new commissioner, Andrus Ansip, on 28 January 2015. The chair of the project team is Günther Oettinger, member of the European Commission in charge of the digital economy and society

New regulatory bottlenecks

Driven by the changes described earlier, traditional regulatory bottlenecks, such as access to infrastructure, will become less important or even become obsolete, whereas access to the 'machine room' housing the huge data collection and processing capabilities of the OTT players will be (or is already) a crucial bottleneck for all players in the digital services sector.

Market definitions

Will the current set of 'recommended markets' (even the most recent revised list of recommended markets) be a future-proof instrument for regulators and competition authorities? Looking at the Facebook/WhatsApp merger, access to the data collection and processing capabilities ('machine room') of the internet giants seems to be a relevant topic for market definitions, which need to get broader, more flexible and include OTT. They may also be extended beyond national borders or defined at a subnational level (for a good example, see the current subnational initiative at Germany's regulator, Bundesnetzagentur).[7]

In other words, will we continue to differentiate among separated vertical markets and spend considerable time and resources on their definitions, analysis and regular updates?

Definition of services and categories: significant market power (SMP)-based regulation

The names and definitions of the current regulatory categories of 'information society services' and of 'electronic communications services' used in European regulation have become obsolete. The obligations associated with these categories should be reorganised as well as the legal instruments to be used. Luisa Rossi, a regulatory affairs manager at Orange, recently pointed out that:[8]

"The old rules are no longer adequate and yet still apply, while new issues are not addressed and require action. This is why it is now important for the legislative framework and regulatory practices to embrace this phase of development... The starting point for the reforms should be the creation of a digital services category with the reclassification of traditional communication services, followed by the reorganisation of the associated obligations such as transparency and non-discrimination, security, privacy, data retention, emergency services, interoperability and portability. Hence, digital services would be subject to a common set of rules enshrined in a new horizontal European legislation, whichever the provider or the technology used. Such an approach should be preferred to sector specific rules."

Reciprocal regulation

Corporates from neighbouring areas of the economy such as pay TV – to give just one example – have the right to purchase telecoms infrastructure, without there being the reciprocal right of telecoms operators to purchase exclusive media content on a similar basis.

Preference for investments in infrastructure

While it may be desirable to address bottlenecks, such as access to fixed-line or mobile infrastructure (via measures such as unbundling and mobile virtual network operators respectively), is it really desirable that those reselling the capacity should have an advantage over those building it? The consequence of this tilt to the competitive landscape will be that less infrastructure is deployed.

Modernising competition policy

Statements from the European Commission's competition directorate (DG Competition) referring to Austria's mobile operator consolidation discuss the lack of an entrant as if it was a failure – on the contrary, it was a successful experiment to determine whether there was economic viability for a fourth player, and the answer was clear: there was not. A negative outcome from an experiment is not a failure (as Karl Popper said, falsifiability is the criterion of science. It is the logical possibility of being proven false by observation).

So let dynamic efficiency gains work... Current competition policy and practice obviously overlooks that a growing part of the entire digital services market (the OTT players) is completely unregulated and the remainder – a much smaller part of the digital services sector – is strongly micro-regulated. A recent set of papers by Zoltán Papai and Gergely Csorba[9] casts doubt on the assumption that introducing more mobile competitors into a national market is necessarily better for consumers. We should forget the mantra of the crucial importance of the famous 'fourth player' – there is no special magic in the number four...

> **"In telecoms the scope for technology to transform the industry is far more chaotic."**

Regulator's dilemma and challenges

Legislators and regulators have two principal choices in this debate: full deregulation or continued (selective) regulation. A key issue – is regulation really capable of specifying how markets should function? Most would concede this is something that is easier to achieve in industries subject to a slower pace of technological change and disruption, such as utility businesses. By contrast, in telecoms the scope for disruptive technologies to transform the industry (for example, mobile, WiFi, voice over IP, OTT) makes things far more chaotic.

Given this inherent unpredictability, one group argues that there is an argument for allowing the market to take its natural course and that the competitive dynamics of an industry subject to Moore's Law are perfectly sufficient. On the other hand, those who do wish to see continued regulatory intervention argue that the question is rather how better to identify those areas that would benefit from it. The so-called 'three criteria test' remains the preferred yardstick (the presence of sustained barriers to entry, the absence of effective competition, and the inadequacy of existing competition law to deal with the issue). In any case, regulators should do their utmost to stay updated on leading edge developments on a global level to understand better the markets on the move and to base their decisions on these insights.

Spectrum policy

Europe's method of allocating spectrum is one of the least harmonised and least efficient on a global scale. Most industry parties agree that there is an urgent need to harmonise this process, in terms of awarding methods, coordinating the timing of awards, the duration of usage rights and the conditions on which spectrum can be traded. One possibility could be the creation of pan-European licences. However, any such proposals (as per those in the Connected Continent (or single telecoms market) proposal seem bound to raise concerns among the member states.

Stronger instruments for the harmonisation of timetables and awarding methods for licence durations when assigning new spectrum are urgently needed. In particular, Europe should be quick and harmonised in allocating and assigning spectrum for mobile broadband in the 700 MHz band (the second 'digital dividend'). Measures should include:

- No – or significantly higher – spectrum caps
- Perpetual usage rights with a 'use it or lose it' rule imposed
- Fostering a secondary spectrum market.

Net neutrality

Despite heavy opposition from operators, the cable industry association (NCTA) and Republican FCC commissioners, the current state of the debate in the US is on course for a strong net neutrality policy, with the industry now waiting for the full rules to be published. Most industry observers expect that this will create a significant spill-over effect on EU legislation on net neutrality because:

- The debate in the US is more focused and better coordinated than in the EU
- Given the fact that most of the OTT players and content providers are domiciled in the US a strong transatlantic alignment for net neutrality rules makes a lot of sense.

As for the European debate, it should be kept in mind that the original Connected Continent proposal from the European Commission on net neutrality was based on the thesis of co-existence between managed and unmanaged services, a very judicious compromise in the eyes of many industry experts. In the course of the subsequent debates this proposal was subject to massive modifications in the European Parliament and European Council.

The coming weeks will be pivotal for the European telecoms market: if the discussion in the relevant institutions does not lead to a workable compromise the worst case could happen – a collapse of the Connected Continent proposal and a fall-back of the legislative power to the national parliaments, ultimately leading to a patchwork of 28 different legislatures. Taking this scenario into account one might come to the exaggerated conclusion that any European regulation for net neutrality would be better than a patchy mosaic of conflicting rules – a real nightmare for consumers, the telecoms sector and content providers. We should keep in mind that clear-cut net neutrality rules are key for enabling operator innovation with specialised services, subject to transparency and other appropriate safeguards. This is also a question relevant for the competitiveness of the European industry.

Change process in the European Union

Perpetual regulatory intervention tends to necessitate more and complex legislation, and the legislative process is itself fraught with risk, since there may be a tendency for positive proposals to be diluted or even reversed when these highly complex topics are debated.

Benefits of scale

Scale already plays an important role within the industry, and in future there will probably be opportunities to extend scale effects still further. For instance, as platforms standardise around IP technology, greater cross-border synergies should become feasible. This is welcome, since many recent regulatory reforms (such as with termination rates and roaming charges) have arguably reduced the incentive for cross-border consolidation.

Licence to fail

In a dynamic and competitive market, there will be companies that fail. Indeed, the very fact that there are losers actually indicates the success of competition. However, European regulation has often shied away from recognising this. For example, it has been particularly difficult to use the 'failing firm' defence to justify a merger – including in those cases where financial investors would have concluded that the target company could not sustain the level of network and customer investment required to be able to compete effectively.

Even observers looking for regulatory reform rather than programmatic deregulation agree that consolidation of smaller players (so creating stronger entities with margins better able to support investment) would be very positive – hence the widespread support for four to three mobile operators in country consolidation.

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